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The Private Equity Growth Capital Council (formerly the Private Equity Council; hereafter “the Council”) is a Washington, D.C. based advocacy, communications and research organization established to develop, analyze and distribute information about the private equity industry and its contributions to the national and global economy. The Council appreciates the opportunity to provide comments to the Financial Accounting Standards Board (FASB) in response to the proposed Accounting Standards Update, Topic 605, “Revenue from Contracts with Customers” (hereafter ASU).

### **General Applicability**

Council members own controlling interests in companies across a wide swath of industries. In many cases, the proposed ASU would have a mild and largely unnoticed impact; in others it would result in drastic changes to existing practice. We worry that the ASU’s focus on establishing a “one size fits all” approach may jeopardize the usefulness of financial reporting. We also strongly oppose the proposed retrospective application of the new standards during the three year transition. Given the broad and significant implementation effort required to comply with the amendments and educate users of financial statements about their impact, the additional retrospective application requirement takes on an almost punitive character. During the transition period, companies will effectively be required to compile their revenues in accordance with existing and new GAAP. Once dual reporting systems are built, a high probability exists that they will then be maintained to continue non-GAAP reporting upon effectiveness of the new standard.

### **Carried Interest and Performance Fees**

The proposed ASU would supersede EITF Topic D-96, “Accounting for Management Fees Based on a Formula.” Pursuant to the ASU, reporting entities would be allowed to recognize revenue from satisfying performance obligations “only if the transaction price can be reasonably estimated.” Otherwise, the transaction price would be limited to the amount that is fixed or can be reasonably estimated. The transaction price on variable consideration can be reasonably estimated in cases where the reporting entity has relevant experience with similar contracts. While this would seem to imply that an asset

manager could rely on its historical experience to reasonably estimate the “probability-weighted amount of consideration” it expects to receive, historical experience is judged to be less relevant when the consideration is exposed to “volatility in the market” or other external factors. Example 18 in the implementation guidance and illustrations would preclude an asset manager from recognizing performance fees based on an index despite previous experience with many similar contracts.

At the same time, the ASU provides an exemption for contractual rights received within the scope of Topic 825 (financial instruments). We understand this scope exemption to include “carried interest,” which is a contractual right to a proportional share of an investee’s net income and therefore properly classified as an equity instrument. In the financial statements of the investee the carried interest is included in the equity section and represents an allocation of income to the holders of the carried interests in accordance with terms of the instrument. The holder of the carried interest may account for the carried interest as an equity method investment and increase its investment account for the amount of profits allocated to its interest.

Many asset managers have performance fee arrangements that are currently accounted for in a manner similar to carried interests that result in the asset manager receiving a performance fee after the investors have received certain preferred returns. In addition, several asset managers account for their carried interest earnings allocation within revenue (effectively the same as D-96 method 2) rather than reflect such earnings as equity method earnings. To the extent that the measurement of the returns and related performance fees are based on an index or other factors that are variable, the amount of the fee can fluctuate. In the typical arrangement the manager is entitled to the fee if the contract is terminated. While we agree that carried interest should be exempted from the ASU, the exposure draft potentially creates significant inconsistency of the timing of the recognition of carried interest relative to performance fees. For example, a performance fee earned subject to the achievement of minimum return levels, or high water marks, in accordance with an investment advisory agreement could not, it appears, be recognized based on investment performance during the period unless the consideration is final and not subject to potential revision.

Rather than create this disjoint treatment, we encourage the Board to revisit the “reasonably estimated” standard and allow reporting entities to record revenue based on the liquidation value of the portfolio on the reporting date. Market participants look to changes in the embedded gains on investment portfolios as a measure of economic performance. We fear that failure to adjust this standard could compromise the usefulness of financial statements and will cause investors to seek alternative performance measures. We are also concerned that the ASU could create discrepancies between the periods during which revenue and expenses are recognized. This could introduce a volatility in income measures that does not exist in reality and further compromise the usefulness of financial statements.

## **Performance Obligations in the Private Equity Context**

Private equity firms' revenues primarily consist of management fees, advisory, transaction, and monitoring fees, and investment income (carried interests are typically an earnings allocation based on equity as described above). Applying the ASU to the fee-based revenue streams would be complex absent further clarification because the services performed are distinct, but related contractually. For example, management, transaction and monitoring fees are received in exchange for distinct services that are priced and sold on a standalone basis by wealth managers, investment banks, management consultants, and other business service providers. The standalone transaction price for these obligations is not clear at contract inception, however, because investment advisory agreements generally require private equity firms to reduce the amount of base management fees payable by an amount equal to a portion of the advisory and management fees received. To further complicate the analysis, carried interest and performance allocations are generally measured on a net-of-fee basis, which involves fee waivers in some circumstances.

The wording of the ASU seems to imply that these various distinct revenue sources should be combined because they are not sold separately by the asset manager and the asset manager earns these fees as a result of its position as manager. Even though the pricing is pursuant to heavily negotiated contracts with the limited partners (LPs) and other components pursuant to specific investments, the ASU would seem to convert these distinct revenue sources into a single estimated transaction price to be recognized over the estimated service period. This will result in revenue being deferred substantially past collection and risk of return. Fundamentally, this will result in dual revenue recognition processes – GAAP and non-GAAP.

Management fees are earned in exchange for distinct services provided continuously and therefore most properly accounted for on a straight-line basis as specified in paragraph 33(c). However, the assessment base on which private equity firms earn fees generally changes over the expected duration of the contract. Most agreements assess fees on a fixed percentage of committed capital during the “commitment period” after which time the fee assessment base switches to amount of capital invested. This is due to the different types and levels of services provided continuously during these distinct periods. The services provided during the commitment period consist largely of identifying investment opportunities, forecasting market developments, and related due diligence. The services provided during the subsequent period focus largely on adding value to the investment and seeking opportunities to exit the investment at an attractive valuation. We are concerned that the wording of the ASU would require estimated fees during the commitment period and the subsequent period (which is separately priced and measured on remaining invested capital), to be combined and recognized straight-line over the estimated life of the partnership agreement. This has the outcome of deferring revenue past when it has been collected and beyond any potential right of return.

## **Onerous Performance Obligations**

Private equity firms often enter into contracts to serve as the general partner (GP) to a limited partnership where the fixed management fee is insufficient to cover the expected costs of fulfilling the contract. If asset managers cannot recognize variable considerations in the transaction price, we fear that some may argue that an onerous performance obligation exists in cases where the probability-weighted costs of satisfying a performance obligation exceed the fixed portion of the transaction price. This would require a reporting entity to recognize a separate liability and a corresponding expense *where no expected loss actually exists*. To avoid this outcome, we encourage the Board to clarify that the unit of account for applying an onerous test is at the contract level, which would include both fixed and variable consideration. As discussed in Basis for Conclusions Number 136, a loss should be recognized only if the remaining performance obligations considered together – i.e. the fixed management fee plus the variable performance allocation in the case of private equity – are expected to be loss-making.

The ASU would also require the reporting entity to provide a reconciliation from the opening to the closing balance of the liability recognized for onerous performance obligations each period. As explained in Basis for Conclusions 132, this would provide the reporting entity with the opportunity to update its measurement of the liability “for reasons other than an entity’s transfer of goods or services to the customer.” Presumably this would allow entities to recognize reductions in expense in cases where input prices fall or other factors result in changes in the expected cost of fulfilling the obligation. But in the context of straight-line recognition of costs associated with continuous service obligations, changes to the onerous performance liability could only come from increases in the transaction price.

Consider the asymmetry this would create: favorable price movements of input costs could be recorded as a reduction of expense and cause the obligation to cease to be onerous during that period; conversely, favorable price movements of assets held in a portfolio with a multiyear service agreement could *not* be used to reduce the recorded value of the liability. Given the requirement that the liability be measured as the amount of direct costs to satisfy the performance obligation less the allocated transaction price, a continuous service obligation would only cease to be onerous when the reporting entity could recognize the variable consideration associated with the contract. The ASU should therefore be clarified to allow reporting entities to include expected performance fees and other gains when determining whether an onerous performance obligation exists, even if such revenues are not reasonably estimable.

## **Conclusion**

The Council believes that the proposed ASU could decrease the usefulness of financial statements if accepted in its current form. We believe the reasonably estimable standard does not reflect changes in economic circumstances, creates unnecessary complexity, and could cause the users of financial statements to seek alternative



metrics to measure financial performance. The ASU's standardized approach to defining separate performance obligations is highly problematic when applied to private equity given the distinct services but often interconnected pricing. We encourage additional guidance on this issue, as well as the appropriate recognition of fixed fees applied to variable asset bases. We also seek clarification that reporting entities are able to include expected performance fees and other gains when determining whether an onerous performance obligation exists, even if such revenues are not reasonably estimable. Finally, we strenuously oppose the proposed retrospective application of the new standards and question the merits of the overall exercise given that some deviation of revenue recognition rules based on industry seems appropriate.

Please feel free to contact me at 202-465-7700 if you would like further clarification or additional information.

Very truly yours,



Douglas Lowenstein,  
President and CEO